



Comptroller of the Currency
Administrator of National Banks

Concentration of Credits (Section 216)

Comptroller's Handbook

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Assets

Concentration of Credits (Section 216)

Introduction

National banks as well as examiners must identify and analyze a wide variety of concentrations. Credit concentrations, by their very nature, are dependent on a key factor, and, when weaknesses develop in that factor, it adversely affects every individual loan making up the concentration. The supervision of credit concentrations must be maintained at a high level. It is also essential that examiners recognize the level of supervision in judging such credits.

Examination procedures for concentrations of credit should be performed concurrently with those in the various loan sections in this handbook. Examiners assigned to those departments are responsible for gathering loan liability information on borrowers or groups of borrowers and for evaluating any concentrations. Cash items, overdrafts, contingent, and all other direct and indirect obligations should be accumulated by the examiner assigned to the department in which the credit review is performed. That examiner also checks central liability files for any additional debt or affiliated advances.

The limitations imposed by the provisions of 12 USC 84 were intended to prevent an individual or a relatively small group from borrowing an unduly large amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. Although many credit concentrations are permitted under the statute, as a matter of policy, such relationships should be controlled and receive a more in-depth periodic review than other portions of the loan portfolio. Before senior management can limit the bank's involvement or perform the necessary review, it must recognize the various types of concentrations and implement accounting systems to retrieve the information necessary to monitor concentrations.

A concentration of credit consists of direct, indirect, or contingent obligations exceeding 25 percent of the bank's capital structure. That includes the aggregate of all types of loans and discounts, overdrafts, cash items, securities purchased outright or under resale agreements, sale of federal funds, suspense assets, leases, acceptances, letters of credit, placements, loans endorsed, guaranteed or subject to repurchase agreements, and any other actual or contingent liability. Concentrations involve one borrower, an affiliated group of borrowers, or borrowers engaged in or dependent on one industry. A concentration also may result from an acquisition of a volume of loans from a single source, regardless of the diversity of the individual borrowers.

In recognizing a concentration, it is important to determine the key factors germane to credits within the loan portfolio. Loans concentrated in one borrower are, to a large degree, centered in, and predicated on, the financial capability and character of that individual or entity. Loans centered

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in an affiliated group are susceptible to a domino effect if financial problems are experienced by one or a few members of the group. Concentrations within, or dependent on, an industry are subject to the additional risk factors of external economic conditions and market acceptance that might equally affect all members of the group.

An easily recognizable concentration of credit is advances to a single borrower under the exceptions to 12 USC 84. Because of the specific exceptions within that statute, senior management may become complacent in approving additional credit to the borrowers. As in any credit advance, an element of risk is present, and potential for loss should remain the major concern. Prudent banking would dictate certain restrictions not imposed by statute. Every loan proposal sheet submitted to the board of directors or its committee should include a listing of the borrower's outstanding loans as well as any outstanding obligations to affiliated interests. In reviewing concentrations within the portfolio, those sheets should be used and the amount of liability updated as of the examination date. At the time credit files are reviewed, information regarding officers and affiliated companies should be transcribed onto the examiner's line sheet.

One concentration of credit which requires good internal reporting to ascertain its existence involves loans which may be advanced to a group of borrowers predicated on the collateral support afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a listed concern or a closely held enterprise, a concentration may exist in the underlying collateral.

Large metropolitan banks lend to a wide variety of industries, and portfolio risk is spread among a large group of borrowers. Banks aware of the inherent risk of credit concentrations usually analyze the major companies within an industry and limit themselves to two or three companies that offer the best present or potential relationship. Maintaining their status as regional or nationally recognized lending institutions, they may become a party to additional credits via participation or as members of a consortium of banks. In such banks, loans are assigned to officers by category, i.e., one or two loan officers may handle transportation loans or loans to food manufacturers. That allows those loan specialists to become knowledgeable about all facets of a particular industry. Unless controlled, an aggressive loan officer may attract a large number of companies and develop a heavy concentration within the portfolio.

Although each loan in a concentration may be of sound quality and profitable, a periodic review should be made of industry trends and the credits' susceptibility to external factors. Historically, such external occurrences have been manifested in railroads, aerospace, electronic data processing, and real estate investment trusts. When industry problems

begin to surface, banks are quickly awakened by unreported concentrations that were allowed to develop.

Another type of concentration that may go undetected involves groups of borrowers who handle the same manufacturer's product. For example, the bank may finance three dealers in floor planning a particular brand of mobile homes, as well as discounting customers' conditional sales contracts. Any one of the dealers could constitute a concentration when direct obligations are combined with the indirect paper. An additional concentration may exist with the common key factor of brand of mobile homes. During a model year, certain defects may become evident, and adverse publicity may hamper sales for that particular manufacturer. Governmental agencies may impose restrictions until the defect is corrected, and customers whose paper was discounted by the bank may halt payments until they are satisfied. The situation may only cause a temporary drop in sales and a few dissatisfied customers. However, it is possible that a large portion of the portfolio may be in a slow status and become of questionable collectability.

That illustration is intended to point out how concentrations may seriously affect the condition of a bank's loan portfolio although the borrowers may appear completely independent. In addition to the concentrations that might exist in the single borrower and the common manufactured product line, a third concentration might exist in the number of mobile home dealers being financed.

Concentrations also occur in banks located in towns economically dominated by one or a few business enterprises, which may grant a substantial percentage of their loans to the enterprise(s) and its employees. Curtailment of operations may result in heavy unemployment where other job opportunities are nonexistent, and stopped operations can pose a serious threat to the economy of the entire town. In such a situation, even if the company is not borrowing from the bank under examination, current financial information on it should be on file. The bank should code all loans to employees of a single company and maintain continuing controls on the outstanding debt. It is difficult to evaluate the further effects of such a situation on other merchants borrowing at the bank who are heavily dependent on such companies. To determine the concentration, it is only necessary to include loans directly involved, including those to the company, its employees, and any supplier whose business is dependent on the company.

Banks located in farming, dairying, or livestock areas may grant substantially all their loans to individuals or concerns engaged in and dependent on that industry. Concentration is commonplace and necessary if the bank is to perform the function for which it was chartered. Bankers in such areas normally have a close relationship with their borrowers and

an in-depth knowledge of the industry they serve. However, records should be maintained dividing the portfolio into various general categories. Management should be aware that a certain percentage of the loan portfolio is predicated on the successful harvesting and marketing of a specific crop or on the sale of a type of livestock. That information provides a useful tool in determining adjustments that might be made to reduce inherent risk. Participations or arrangements with governmental agencies are distinct possibilities. It is imprudent to wait until a problem develops before seeking possible remedies.

Banks may go outside their normal trade area to grant, or acquire from one or more sources, a fairly substantial amount of loans. Such loans should be regarded as a "class of borrower," regardless of diversification in type of industry, unless the bank is well able to maintain adequate borrower contact and collection control. Out of normal area loans should not be acquired by banks unless they are adequately staffed and equipped to service them.

A further type of concentration involves extensions of credit to a foreign government, its agencies, and majority-owned or controlled entities. Credit to specific private enterprises can be included in such concentrations if an interrelationship exists in the form of guarantees, moral commitments, significant subsidies, or other factors that indicate dependence on the public sector.

It is practically impossible to list all the types of concentrations that might exist. The examiner should use informed judgment in deciding the extent of an investigation to disclose possible concentrations. It should not be the examiner's job to search for and determine concentrations. That information should be available and reported to the board of directors periodically. If the bank does not identify and analyze concentrations, the examiner should review the portfolio and present his or her findings to senior management. The examiner should request that bank personnel detect and code loans which fall into the various categories and then generate reports on outstanding loans in each category. When concentrations are reported, the examiner should test check to ascertain that all loans that make up a concentration are being reported.

The examiner-in-charge, together with the examiner assigned "Loan Portfolio Management," should review the schedule of concentrations prepared by the examiners assigned to various loan departments. Schedules also should be obtained from examiners assigned to other departments, such as investments due from banks and other assets. That review determines whether the scheduled concentrations should be detailed in the report of examination as supporting information, or whether they are subject to sufficient criticism to require prompt remedial action by the bank.

The handling of concentrations in the report of examination is flexible and requires some degree of examiner judgment. Credit concentrated in a particular industry, product group, or employer may be handled in comments relating to distribution on the Loan Portfolio Management page of the report of examination. Support for such comments should be in the working papers. Detailed listing of individual borrowers is not required on the Concentration of Credit page of the report of examination unless the examiner feels such information would be meaningful to the reader. Loan and investment concentrations within banks' portfolios should also be detailed by industry, state, county, or municipal obligor on the Statistical Data Sheet when considered meaningful. This information allows the OCC to identify banks that are vulnerable to deterioration within a particular industrial or public sector.

The procedural steps in this program should be performed by the examiner assigned to "Loan Portfolio Management." Examiners assigned to asset categories should be asked to obtain or prepare the information necessary to complete this program and to perform the appropriate procedural steps.

1. Complete or update the Concentration of Credits section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request the bank's schedules of concentrations which are reported to the board of directors and/or senior management at regular intervals, and:
 - If schedules are not current, update and/or have bank personnel update them as of the examination date.
 - Request that examiners review the schedules for reasonableness relative to information developed in performing the examination procedures for the various departments.
5. If schedules of concentrations are not maintained, or if the listing is incomplete, prepare or obtain the following schedules of obligations which exceed 10 percent of the bank's capital structure:
 - Loans collateralized by a common security.
 - Loans, contingent liabilities, and/or other obligations to one borrower or related group of borrowers.
 - Loans dependent upon a particular crop or herd.
 - Aggregate loans to major employers in the service area, their employees, and their major suppliers.
 - Loans within industry groups.
 - Out of normal territory loans.
 - Aggregate amount of paper purchased in whole or in part from any one source.
6. If the schedules were prepared by others, have examiners in the departments review them for reasonableness relative to information

developed in performing the examination procedures for the various loan areas.

7. Obtain a listing of due from bank accounts.
8. Obtain from the examiner assigned "Investment Securities" the schedule of investments and money market instruments that exceed 10 percent of the bank's capital structure.
9. Combine the schedules obtained in steps 4 through 8, and determine concentrations that equal or exceed 25 percent of the bank's capital structure. The remaining procedures apply only to such concentrations.
10. From the schedule of loans collateralized by a common security, eliminate all borrowers for whom the common security can be considered excess collateral, then review:
 - Trend in market prices.
 - Current financial information, if appropriate.
11. For loans dependent upon a particular crop or herd:
12. Review the bank's files for information on market conditions, future markets, and estimated prices.
13. Determine any adverse trends that might affect payment of the concentrations.
14. For loans dependent upon major employers:
15. Review financial and other available information on the company, and evaluate its ability to continue as an ongoing entity.
16. Review excerpts from trade papers or periodicals in bank files to determine that bank management is adequately informed on the business activity of the company.
17. Note any adverse trends that might affect the collectability of the loans in the concentrations.
18. For loans within industry groups:
19. Review financial and other available information on each industry, and evaluate its ability to continue as a viable industry.
20. Review bank's files to determine that management is adequately informed on the activities of the industry.

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Procedures

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- 21.** Determine any adverse trends that might affect the collectability of the loans included in the concentrations.
 - 22.** Determine from schedules and discussions with management which loans or investments represent reportable concentrations (see Examining Circular 219), and obtain an estimate of the level of concentration, as a percentage of capital, for each concentration.
 - 23.** For due from bank accounts, inquire as to the reasonableness of the account relative to the activity and services provided.
 - 24.** Discuss with management:
 - 25.** The adequacy of written policies regarding concentrations of credit.
 - 26.** The manner in which bank's officers are operating in conformance with established policies.
 - 27.** Concentrations which will appear in the report of examination.
 - 28.** The adequacy of available information on concentrations for management and the board of directors.
 - 29.** Any matter requiring immediate attention.
 - 30.** Prepare, in appropriate form, all information regarding concentrations for inclusion in the report of examination. A comment should be made regarding each concentration. Examiners should avoid direct requests for reduction in the concentration unless facts are included which would support such action.
 - 31.** Prepare information on reportable loans and investment concentrations for inclusion on the Statistical Data Sheet.
 - 32.** Prepare a memorandum, and update work programs with any information that will facilitate future examinations.
 - 33.** Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

Appendix A: Internal Control Questionnaire

Concentration of Credit Policies

1. Has a policy been adopted which specifically addresses concentrations of credits?
2. Does the policy include deposits and other financial transactions with financial institutions?
3. Have controls been instituted to monitor the following types of concentrations:
 4. Loans and other obligations of one borrower?
 5. Loans predicated on the collateral support afforded by a debt or equity issue of a corporation?
 6. Loans to a company dominant in the local economy, its employees, and major suppliers?
 7. Loans dependent upon one crop or herd?
 8. Loans dependent upon one industry group?
 9. Loans considered out of normal territory?
- 10.4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency _____)?
- 11.5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?
- 12.6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of:
13. Participations?
14. Arrangements with governmental agencies, such as:
 - Guarantees?
 - Lending arrangements?
15. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

Conclusion

1. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____ (good, medium, or bad).